SAVING FOR A COLLEGE EDUCATION

A mini-lesson for:

high school counselors and teachers
parents and students
adult and community educators

This lesson includes learning objectives, background Information, discussion questions, activities and additional sources of information.

OBJECTIVES

Learners will:

- consider saving and investing alternatives to finance a college education
- develop an investment strategy for a college fund

Planning To Meet College Costs

The benefits of a college education are many. Young people who earn a college degree are likely to have a higher income, an occupation that offers more opportunities for growth and a more satisfying work life than those who do not. The college experience helps people learn to think critically and analyze information, tools that are important when entering a highly technical workplace.

The costs of a college education have more than doubled in the last ten years. In addition to the escalating cost of tuition, add approximately $4,500 in annual costs for room and board, fees, books, and transportation. Paying for college is a manageable feat, however, and the earlier parents start saving for college, the more flexibility and choice they will have. Ideally, parents should start saving for their children's' college education when they are born. Unfortunately, most families have other significant financial goals to fund during this time, such as buying a house and saving for retirement. So saving for college requires a special kind of savings program. This is especially significant for families who will have the overlapping expenses of more than one child in college at the same time.

Funding college expenses can be more aggressive if college is ten or more years in the future. Use lower risk investments when college is in the near future. With a long-term investment time frame, your money can grow in a variety of investment options. It is never too early or too late to start saving for college expenses.

The amount of money that you can save will be influenced by household income and expenditures, including student income and expenditures. Most families cannot afford to meet college expenses out of current income, so they look for investments and saving plans that have a reasonable balance of growth, safety and yield. The key to a college savings plan is to invest regularly and to start as soon as possible. When you consider saving for college to be a long-term goal, you gain the following advantages:

- investments are likely to grow significantly over time
- savings grow compounding of earnings over time
- families can set aside smaller amounts regularly over time
- parents can finance other family goals while saving for children's education
- college students can complete college with less debt
- students will have more college choices

Factors Affecting A College Savings Plan

Gather information and estimate dollar amounts of the following factors as you develop a college savings plan tailored to your family situation.

- annual estimated cost of colleges being considered
- number of years until the student begins college
- amount that can be set aside annually for college savings
- amount likely to be available from household income during the college years
- student employment income to be applied to college costs
- eligibility for student loans and willingness to assume debt for college expenses

Evaluate various college savings and investment alternatives for differences in safety and yield. Purchasing power can be lost over time if so-called safe investments do not outpace inflation. An investment vehicle that has consistently outpaced inflation over time is stock ownership, yet the short-term risks of loss from stocks are greater than for fixed income investments.

See **Interactive Calculator: What will it take to save for a college education?** at http://www.calcbuilder.com/cgi-bin/calcs/SAV4.cgi

Investment Strategy

To determine the appropriate savings and investments program, consider:

- Risk -- the possibility that the yield will be less than expected
- Return -- total income from an investment
- Liquidity -- the convenience and speed that an asset can be converted to cash
- Time frame -- the number of years available to invest

It is especially important to balance these four considerations to reduce risk while increasing return. Liquidity provides access to funds when the college years begin.

Inflation. Inflation reduces the purchasing power of money. In inflationary times, the financial return on investments may not keep pace with the rate of inflation, so purchasing power is decreased. The desire to have investment returns keep up with inflation should be balanced against the potential loss of principal in high yield but potentially risky investments. A suggested guideline is to choose investments that yield the inflation rate plus three percent. Promised returns above this amount may carry high risk.

Diversification. Diversification is the process of reducing risk by spreading money among various types of investments. Because certain investments perform better than others in certain economic conditions, you can spread the risk by selecting investments with varied risk-return characteristics. By putting your money into a variety of investments, you lessen the risk of loss due to any one investment performing poorly.

Using The Pyramid Of Investment Risk

The Pyramid Of Investment Risk illustrates choices among high, medium and low risk investments and various rates of return at various age levels. When you make investment choices to fund a college education, consider the age of the child and the time frame. A longer time frame allows you to take advantage of investments that may offer a better return at greater risk. The sooner you need the money the less risk you can afford to take because safety becomes more important than a high rate of return. Balance your investments between high, medium and low risk in a college fund.

Birth to Age 12

With time on your side, you can begin investing early, save regularly and increase the amount as your income grows. Consider investing in stocks or growth-stock mutual funds. Over the long run, stocks have provided the highest return. Be prepared to accept the rise and fall of the market. You have the time to wait for prices to rise if the stock market drops.

A growth-stock mutual fund can be a safe and easy way to obtain aggressive growth. A mutual fund is a company that invests the pooled money of its shareholders in various types of investments. The funds often accept small sums of money and have an experienced fund manager who buys and sells giving you maximum returns.

Ages 12 to 16

During these years you still look for growth but may want to move to lower risk investments. Bonds are a good choice because they have less risk of falling sharply in value. Bonds are certificates representing a loan of money to a corporation or government for a specific period, in exchange for a promise to repay the bondholder the amount borrowed plus interest. You can buy a series of bonds that will mature in each year of college. This is called laddering.

Government securities include treasury bills, notes and bonds. They can be short, medium or long term so they can be purchased to meet your time requirements. They are the safest of all bonds but also have a lower rate of return than many other investments.

Another alternative is mutual funds which may offer less risk. These funds may be invested in government securities, stocks, bonds or a combination of securities. Each fund has an objective which determines the types of securities it contains. The risk is related to the goals and safety factors defined by the fund. The return on mutual funds depends on the performance of securities in the fund.

Ages 16 to 18

Now is the time to move to low-risk investments to protect the principal. Good choices include short-term government securities, savings bonds, money market funds and certificates of deposit. Savings bonds have interest rates that are usually higher than a savings account or money market fund. They mature at a specific future date and have a variable interest rate. Money market funds are offered by banks and mutual fund companies and are invested in short-term investments that have high credit ratings. They have a higher interest rate than savings accounts. Certificates of Deposit are issued by banks and guarantee a fixed interest rate for a specified time. CDs may be purchased in amounts as low as $500 but most are for $1,000, $5,000 or $10,000. They are low risk when FDIC insured and also have higher rates of interest than savings accounts. Each of these options offer safety of principal, but provide little protection from inflation.

Other Alternatives

Several additional alternatives could be considered when financing a college education. A few states offer the opportunity to prepay college tuition. You can buy 1, 2, 3 or 4 years of college. Problems may arise if the student decides to attend college out of state because each state has its own policies and procedures. Consider the requirements and the refund policy if the student decides not to attend college.

It is possible to borrow from a 40l(k), retirement account, but the loan must be repaid within 5 years. Or you may consider a home equity loan to pay for college expenses, making it possible to borrow against the equity in your home. This "second mortgage" may also be tax deductible.

A variety of other saving and investment options are advertised to help save for college funds. Evaluate them carefully for return and risk. For example, cash-value life insurance policies are sold to help save money for college, however, the rate of return may be far less than the other investment alternatives.

Rule of 72. The Rule of 72 is a useful tool for investors. With this rule, you can calculate how long it will take your money to double at a given interest rate, if you reinvest the earnings.

72 Divided by the Percentage Rate of Return
Equals The number of Years Needed to Double Your Money

For Example, Paul Joseph has $10,000 invested at 6% for college expenses. How long will it take him to have the $20,000 he needs to pay for college in 13 years? (72 divided by 6 equals 12 years)

When saving for college, key ideas are to begin early, save regularly, consider risks and rewards of various investment types and diversify among investment options. Investors who review and adjust their investment portfolios regularly are likely to earn more over time than those who do not.

DISCUSSION QUESTIONS AND TOPICS

1. What are the key factors to consider in an investment decision to pay for college?

2. What information will determine how much your household can save for college?

3. How can you reduce risk in your investment selections?

4. When considering investments to pay for college, what information would be helpful to you?

ACTIVITIES

1. Select investments for a parent with $1,000 to invest for the college education of a child who is 1 year old. Then choose appropriate investments for a $1,000 investment for each year until the child is 17 years old.

2. Gather information and estimate dollar amounts of the following factors as you develop college savings plan tailored for your family situation:

- annual estimated cost of colleges being considered
- number of years until student begins college
- amount that can be set aside annually for college savings
- amount likely to be available from household income during the college years
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3. Using the Wall Street Journal, your computer, or a similar market data source, follow the prices of two mutual funds for several weeks. Compare the funds' performance over 1, 3 and 5 year periods with other funds that have similar objectives, such as growth or income. Draw conclusions as to whether these funds would be appropriate investments for your family's college savings plan.

4. Give Students Saving and Investment Quiz.

See list of **Savings Calculators** on the Internet at
http://www.dfi.state.in.us/conscredit/MiniLessons/savings_calculators.htm

See our **Mini-Lesson on Savings & Investments** at
http://www.dfi.state.in.us/conscredit/MiniLessons/savings_and_investments.htm.

SAVINGS AND INVESTMENT QUIZ

1. A certificate of deposit must be held for a set amount of time such as six months or a year.
   - ❏ True
   - ❏ False
2. Compound interest refers to money earned from buying a tax-exempt investment.
   - ❏ True
   - ❏ False
3. A share of stock represents ownership in a company.
   - ❏ True
   - ❏ False
4. A mutual fund is an investment issued by a state or local government agency.
   - ❏ True
   - ❏ False
5. Compound interest makes money grow faster.
   - ❏ True
   - ❏ False
6. Compound interest refers to money earned from buying a tax-exempt investment.
   - ❏ True
   - ❏ False
7. A certificate of deposit must be held for a set amount of time such as six months or a year.
   - ❏ True
   - ❏ False
8. A share of stock represents ownership in a company.
   - ❏ True
   - ❏ False
9. Treasury bonds are a safer investment than real estate.
   - ❏ True
   - ❏ False

10. The lowest interest rate is usually earned on a:

- ❑ money-market account.
- ❑ certificate of deposit.
- ❑ passbook account.
- ❑ mutual fund.

11. The total interest earned on $100 for two years at 10 percent (compounded annually)
would be:

- ❑ $2
- ❑ $21
- ❑ $11
- ❑ $10

12. Based on the rule of 72, money earning 6 percent would take about (fill in the blank) years to double.

- ❑ 6
- ❑ 8
- ❑ 9
- ❑ 12

13. Which of the following increases the value of my money in stocks?

- ❑ Increase in price per share
- ❑ Dividends
- ❑ Stock splits
- ❑ All of the above

14. Owning shares of stock:

- ❑ can increase the value of my money
- ❑ can decrease the value of my money
- ❑ provide income from dividends
- ❑ All of the above

15. An example of a company's debt is a:

- ❑ corporate bond.
- ❑ share of stock.
- ❑ mutual fund.
- ❑ municipal bond.

16. The investment with the most risk would be:

- ❑ a savings account.
- ❑ U.S. Treasury bonds.
- ❑ corporate stocks.
- ❑ corporate bonds.

SAVINGS AND INVESTMENT QUIZ

1. A certificate of deposit must be held for a set amount of time such as six months or a year.

   ❏ True

2. Compound interest refers to money earned from buying a tax-exempt investment.

   ❏ False

3. A share of stock represents ownership in a company.

   ❏ True

4. A mutual fund is an investment issued by a state or local government agency.

   ❏ False

5. Compound interest makes money grow faster.

   ❏ True

6. Compound interest refers to money earned from buying a tax-exempt investment.

   ❏ False

7. A certificate of deposit must be held for a set amount of time such as six months or a year.

   ❏ True

8. A share of stock represents ownership in a company.

   ❏ True

9. Treasury bonds are a safer investment than real estate.

   ❏ True

10. The lowest interest rate is usually earned on a:

    ❏ passbook account.

11. The total interest earned on $100 for two years at 10 percent (compounded annually)
    would be:

- ❏ $21

12. Based on the rule of 72, money earning 6 percent would take about (fill in the blank) years to double.

    - ❏ 12

13. Which of the following increases the value of my money in stocks?

    - ❏ All of the above

14. Owning shares of stock:

    - ❏ All of the above

15. An example of a company's debt is a:

    - ❏ corporate bond.

16. The investment with the most risk would be:

    - ❏ corporate stocks.

SOURCES OF ADDITIONAL INFORMATION

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Internet

Indiana Department of Financial Institutions Web Site for this Mini-Lesson:
http://www.dfi.state.in.us/conscredit/MiniLessons/savcoled.htm

See our Web Site on Financial Security Planning at
http://www.dfi.state.in.us/conscredit/financial_security_planning.htm .

For more information on savings, see Money Central Savings.
http://moneycentral.msn.com/articles/smartbuy/saving/contents.asp

The **Online Money College Guide** at
http://www.money.com/money/depts/investing/college/

A college savings calculator that figures out exactly how much you need to pay for college.

See Interactive Calculator **What will it take to save for a college education?** at
http://www.calcbuilder.com/cgi-bin/calcs/SAV4.cgi